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Estate Transfer under the Proposed American Families Plan

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On May 28th the Biden Administration released a general explanation of its proposed tax changes. This includes an explanation of proposed changes in the American Families Plan that would tax transfers of appreciated property by gift or upon death, tax capital income for high-income earners at ordinary rates, increase the top marginal income tax rate, and apply the 3.8-percent Medicare tax to all trade or business income of high-income taxpayers, including transfer of assets.

Transfers of appreciated property by gift or at death will be treated as "realization events" which require recognition of gain. That is, the transfer will be taxed like a sale. The gain is taxable to the one making the gift or to the estate of the one who dies (decedent). The proposal would apply to gifts and deaths beginning in 2022.

There would be no adjustment or step-up in basis to fair market value at death when calculating the transfer tax. The purpose is to tax the appreciation or gain in value of assets that have not been taxed before. Gain is calculated by subtracting the adjusted basis from fair market value at the time of gift or death *as if* the property were sold. Adjusted basis is the original cost plus improvements minus depreciation. See the article ***Proposed Gift and Estate Tax Changes*** by Laura Powers in last month's ***Economic and Policy Update***.

The transfer tax is not an estate tax, but a new tax on the unrealized gain at the time of death or gifting. Both transfer tax and estate/gift tax will apply to property passed by death or gifting.

Current state and Federal estate taxes continue to apply and would not be changed by the proposal. Basis in assets would continue to be automatically adjusted or "stepped-up" to fair market value at death before estate taxes are calculated. The transfer tax would be deductible on the decedent's estate tax return.

Exclusions Under the Proposal

Property transferred by a decedent to a U.S. spouse or to charity would not be subject to the transfer tax, but it would *not* receive step-up in basis. The basis of the decedent would be gifted or “carried over” to the one receiving the property. Charitable deductions would not be valued at fair market value but at the decedent’s basis in the property.

There is a $1 million per person exclusion from recognition of gains on property transferred by gift or held at death. The exclusion is portable to a surviving spouse. Any portion not used by one spouse can be used by the surviving spouse, making the exclusion effectively up to $2 million per married couple.

The current $250,000 per person exclusion for gain on a principal residence still applies to all residences. The exclusion remains portable to the decedent’s surviving spouse, effectively making it $500,000 per couple.

Gains on tangible personal property such as household furnishings and personal effects (excluding collectibles) are exempt.

Example 1

Farmer and spouse die in 2022. Fair market value of the estate is determined to be $5 million. Basis in assets totals $2 million. Gain is $3 million. Gain on the residence is under $500,000. After subtracting the couple’s $2 million personal exclusion the amount subject to transfer tax is $1 million.

Example 2

Same circumstances except that the farmer and spouse gift the property in 2022. The amount subject to transfer tax is the same: $1 million.

Basis for the Person Receiving the Property

The recipient receives a step-up to fair market basis in property received by inheritance. In Example 1 the recipient basis in the property is $5 million.

The total basis of property acquired by gift would have two components. The recipient would receive the donor’s basis for the property covered by the $1 million per person exclusion. The amount of property not covered by the personal exclusion would receive a step-up to fair market basis. In other words, the amount of the gift that is taxable to the donor gets the stepped-up in basis for the recipient. The recipient basis in property gifted in Example 2 would be $3 million: fair market value in the amount taxed ($1 million) plus mom and dad’s original basis in the amount not covered by their personal exclusion ($2 million).

Payment of the Tax

The proposal does not provide instructions for tax calculations, but it does give some clues. The following example, based on the examples above, provides a rough estimate of the tax due on the transfer tax based on the information given in the proposal. In both examples above, the taxpayers are assumed to file as married filing jointly because 1) both spouses in Example 1 died in the same year or 2) spouses were assumed to be living at the time of the gift in Example 2. No other income is included in the calculations.

Example 3

The first $1 million of the gift would be taxed at capital gains rates, resulting in about $163,170 in Federal tax, plus $38,000 in additional Medicare tax. The remaining $2 million would be subject to ordinary tax rates with the changes in top rate and bracket and the additional Medicare tax. The total tax due on the $3 million would be about $840,595.

Payment of the tax for certain family-owned and operated farms and businesses would not be due until the business is sold or ceases to be family-owned and operated. No definition of family has been given. The authors' original definition of family is those related by lineal descent: from grandparent to parent to children.

The proposal provides for a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets. Family-owned and operated farms and businesses electing to defer payment do not qualify.

The Internal Revenue Service is authorized to require security when reasonable. That is, the IRS may take out a lien on the property to secure the tax-deferred or the 15-year tax payment.

Other Provisions that may Affect Estate Transfer

The top marginal individual ordinary income tax rate increases from 37 to 39.6 percent.

The income threshold for reaching the top income tax bracket is lowered. For example, the top bracket for married filing jointly would drop from the current $628,300 to $509,300. For those filing as single, the top bracket falls from $523,600 to $452,700.

Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million would be taxed at *ordinary income tax rates* for the amount that exceeds $1 million. Current capital gains rates range from zero to 20 percent. This would include the tax on transfer of assets by death or gift. Effective April 28, 2021.

Apply the additional 3.8 percent Medicare tax to all trade or business income of high-income taxpayers with adjusted gross income of $400,000 or more, including transfer of assets.

Repeal the deferral of gain from like-kind exchanges (Section 1031) for amounts exceeding $500,000. Applies to exchanges completed in tax years beginning after December 31, 2021.

Effects on Kentucky Farms

Farm data from farms participating in the Kentucky Farm Business Management program were examined to identify balance sheets with basis in assets, especially basis in land. A total of 320 farms in the program were identified. Of those, 160 (50%) appear to have a taxable amount after the exclusion. That is, subtracting adjusted basis from fair market value listed on the balance sheet resulted in a gain greater than the $1 million personal exclusion for the owner or the $2 million exclusion for the owner and spouse. Fair market value averaged $8.4 million. The taxable amount ranged from $14,000 to nearly $28 million. The average amount subject to the transfer tax was about $3.08 million.

These are commercial-sized, family-operated Kentucky crop and livestock farms. The average farm operates 2,044 acres. The farmer owns 418 acres (20 percent) and rents the other 1,626. The average Schedule F Income reported was $65,514.

The typical Kentucky family farm uses a large portion of rented farmland. The average KFBM farm owns 27% of the land used for production and rents the other 73%. The transfer tax will apply to individual landlords as well. The family farming operation will be adversely affected if it is unable to retain use of this rented land because the transfer tax prompts its sale.

Some landlords are family members that are no longer actively involved in the farm. Depending on how broadly family-owned and family-operated are defined the family farm exclusion may not apply to these landowners at their deaths.

There are other specific provisions in the American Families Plan that will impact gift and estate transfers and will change or limit the way estate planning may be carried out. For more information see:

General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals

"Green Book" Details President's Tax Reform Proposals by Kristine A. Tidgren

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